DEPARTMENT OF STATE REVENUE

Revenue Ruling #2013-05ST
May 2015

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the department's official position concerning a specific issue.

ISSUES

Sales and Use Tax - Authorization Services and Related Services

A company ("Taxpayer") is seeking an opinion as to whether Taxpayer's products are services that are not subject to the Indiana sales and use tax when sold to clients located in Indiana. Specifically, Taxpayer seeks a ruling regarding the following:

1. Whether Taxpayer's in-house usage of its proprietary "activity database" and sophisticated "risk scoring computer model" to provide merchandise return authorization services signifying whether its client is being advised to accept or reject the return (i.e., approved, warned, or denied) is a nontaxable professional or personal service under 45 IAC 2.2-4-2.

2. Whether Taxpayer's add-on service that generates coupons for its clients' customers making returns based on a proprietary, patent solution is a nontaxable professional or personal service under 45 IAC 2.2-4-2.

3. Whether Taxpayer's fee to provide support for the integration of its services with its clients' systems, whether delivered inside or outside Indiana, are subject to sales or use tax when separately stated on customer invoices because they are nontaxable professional services under 45 IAC 2.2-4-2.

Authority: IC 6-2.5-1-24; IC 6-2.5-1-26.5; IC 6-2.5-1-27; IC 6-2.5-1-27.5; IC 6-2.5-1-28.5; IC 6-2.5-2-1; IC 6-2.5-2-2; IC 6-2.5-4-1; IC 6-2.5-4-6; IC 6-2.5-4-16.4; 45 IAC 2.2-1-1; 45 IAC 2.2-4-2; Streamlined Sales and Use Tax Agreement (Oct. 8, 2014)

STATEMENT OF FACTS

Taxpayer is a Delaware corporation that is domiciled in California. It has no employees, business locations, or assets in Indiana, although occasionally its employees may enter Indiana to visit clients or prospective clients, a majority of whom are retail merchants ("Merchants"). Taxpayer provides merchandise return authorization services ("Authorization Services") to their clients, which accounts for ninety-five percent of Taxpayer's revenue. The rest of Taxpayer's revenue derives from a service wherein merchant coupons are generated ("Discount Coupon Services") when customers make returns to Taxpayer's clients.

Taxpayer provides the following facts regarding its request for a revenue ruling:

A Merchant acquires the [Taxpayer's] merchandise Authorization Service to assist it in determining whether the Merchant will or will not accept merchandise returns from one of the Merchant's own customers. The Authorization Service assists Merchants to expedite the handling of returns and reduces the probability of merchandise return fraud, thereby assisting Merchants to accelerate cash flow, lower operating expenses and increase sales.

A Merchant uses the [Taxpayer's] merchandise Authorization Service when a customer attempts to make a merchandise return to that Merchant. To initiate a transaction, a Merchant must swipe its customer's driver's license or state ID card through a VeriFone or similar platform on a Merchant's POS System and transmits the information electronically to the [Taxpayer's] data center in California, where the [Taxpayer's] servers process each transaction and electronically transmits an Authorization Decision back to the merchant regarding whether to accept or reject the merchandise return.

The type of information provided by a Merchant to the [Taxpayer] includes the information on the face of an ID, such as the identification number, the customer's name, address, date of birth, and expiration date. Certain additional information is implicitly supplied, such as the time of day or night of the transaction, the

address of the Merchant's store where the transaction is occurring, and the type of Merchant. Similar to a credit card or check verification, the data is transmitted to the [Taxpayer's] host server for an Authorization Decision to approve the return or exchange through utilization of deterministic rules and statistical models.

Upon receipt of the information provided by the Merchant, the [Taxpayer] performs a two-step analysis at its data center in California. First, the return data described above is run through [Taxpayer's] proprietary, self-created and updated "activity database," which was built in-house and contains all return data that the [Taxpayer] has amassed with the specific Merchant. Any historical data that appears linked to the customer's return data (such as the driver's license number) is identified for any "positive" or "negative" indications.

Second, the return data together with any historical return data (gleaned from the foregoing process) is run through the [Taxpayer's] "risk scoring system." The risk scoring system consists of a highly proprietary and sophisticated computer model which the [Taxpayer] built in-house. The [Taxpayer] considers its models and algorithms to be trade secrets and does not share them with anyone. These models perform a risk analysis applying intricate, complex, confidential and proprietary statistical models, algorithmic processes and other risk assessment tools to the return data and any historical return data, with the goal of making a determination to advise the Merchant as to whether or not the customer's return is too risky for the Merchant to accept. On each transaction that is evaluated, the risk scoring process makes use of multi-variable (multi-variety) non-linear, additive, or logistic regression models which are constructed from a candidate pool of hundreds of different variables (such as the frequency and volume of returns in the past 30 days, the returns at this Merchant's store, the average return amount, the pattern of travel, and the like) that are based on an individual's historical and current transaction information. The number and type of variables may differ for each merchant as well as the relative weight assigned to each variable depending on the Merchant's industry and each Merchant's individual return processes and desired risk levels.

The [Taxpayer's] ultimate goal, by use of its predictive models, is to mitigate the risk to a Merchant from a customer's fraudulent or abusive merchandise return. The aim of the [Taxpayer's] process is to develop accurate predictive risk models and formulae tailored to a particular Merchant or particular industry so as to accurately assess the likelihood that a Merchant customer's return behavior is indicative of fraudulent or abusive return behavior, and thus advise the Merchant as to whether or not to accept a customer's return.

The [Taxpayer's] risk analysts identify and evaluate hundreds of variables that may be relevant in determining return risk for a particular Merchant or industry. Each variable is evaluated using proprietary statistical methods and incorporated into multiple models which evaluate customer risk using non-linear, additive, or logistic regression models. Each variable, during this process, is assigned a set of coefficients or weights in the models to determine its relative impact on risk scoring evaluation. The [Taxpayer's] risk analysts determine the relevant variables and the relative weight to be assigned to each using the [Taxpayer's] highly proprietary selection methodology, which uses statistical modeling software to perform the analysis. Determining the optimal weights involves an iterative process (either a Newton-Raphson algorithm, gradient decent, or similar optimization technique) which evaluates each coefficient using computationally intensive algorithms that perform millions of calculations to determine the weights. The foregoing process is highly complex and requires highly specialized skills. The [Taxpayer's]' risk analysts bring education, training and professional experience skills, including advanced degrees in subjects such as statistics, economics, engineering, and finance and computer science, commensurate with the complexity of the process. The [Taxpayer's] employees have expended many thousands of hours, and the [Taxpayer] has expended a great deal of capital, in developing the proprietary computer models employed in the provision of the [Taxpayer's] Authorization Services, and the [Taxpayer] and its employees continue these expenditures on an ongoing basis testing, enhancing, rebuilding and improving the computer models. Consequently, the [Taxpayer] considers its models and algorithms to be trade secrets and does not share them with anyone.

After analyzing the information using the processes described above, the [Taxpayer] formulates a communication as to whether a return should be accepted or not, and provides its communication to the Merchant recommending whether the Merchant should accept or decline the merchandise return. To that end, a merchant receives the [Taxpayer's] communication (i.e., [Taxpayer's] opinion, advice or recommendation) in the form of an Authorization Decision signifying whether the Merchant is being advised to accept or reject the return (i.e., approved, warned, or denied).

The communication provided by [Taxpayer] to a Merchant, whether or not to accept the return, pertains only to the single return transaction of that one customer and that one return. Even though the same decision logic can be provided to different Merchants concerning return transactions by the same person (e.g., a customer goes to one Merchant to make a return and thereafter goes to a different Merchant

to make another return), this does not guarantee the same recommendation will be made to accept or decline a return because risk parameters specific to the customer and each individual Merchant will vary. In other words, the [Taxpayer] designs and integrates the Authorization Services based on each Merchant's individual return processes and desired risk levels. The [Taxpayer] charges its Customers a separate fee for professional services. The fee for Authorization Services is billed separately on a per-store basis as explained more fully below.

The result of each merchandise return Authorization Service transaction that is performed by the [Taxpayer] for any Merchant is added to the [Taxpayer's] in-house activity database, such that the database is continually updated with new information, which may impact any future merchandise return authorization analyses. Thus, a **revised** database is used each time a merchandise return Authorization Service analysis is performed by the [Taxpayer].

The communication provided to the Merchant, whether or not to accept a particular return, is not provided to anyone other than the specific Merchant who requested that specific merchandise return authorization. The [Taxpayer's] communication, whether or not to accept the customer's return, is nonbinding upon a Merchant.

In addition, the [Taxpayer] offers an add-on service that generates Merchant coupons to customers making returns to the Merchant. The Merchant coupon program is a proprietary, patented solution to achieve up-sell optimization by issuing intelligent incentives following legitimate return or exchange transactions. The coupons are printed by the Merchant directly on the Merchant's return receipts. The up-sell optimization is a technique that drives incremental sales through the use of statistical modeling, simulation techniques, and predictive analytics. For this service (i.e., Discount Coupon Service), the [Taxpayer] receives payment in the form of commissions based on success, defined as incentives used, not just printed.

In providing the Authorization or Discount Coupon Services, Merchants communicate with the [Taxpayer] in one of two ways: (i) VeriFone terminals or (ii) Merchant's point of sale ("POS") system. For some Merchants, the [Taxpayer] may provide countertop VeriFone terminals for the Merchant to use during a brief pilot period to transmit the return information to the [Taxpayer] as well as receive the Authorization Decision for each return authorization, coupon issuance, or both. In this case, the [Taxpayer] does not make a separate charge to the merchant for use of the terminals. Rather, the terminals remain the property of [Taxpayer] and at the termination of an initial pilot period (ranging from 30 to 90-days), all terminals must be returned to [Taxpayer]. Even though the terminals have a useful tax-life of five years, the [Taxpayer] has continued to use the same terminals in pilot programs with various customers over the past ten (10) years. If a Merchant executes an agreement for Authorization or Coupon Services beyond the pilot period, the Merchant will purchase the necessary terminals from third-party vendors. Because the [Taxpayer] uses the terminals in the provision of its services, the [Taxpayer] has not issued its vendors resale certificates and pays sales or use tax on its purchase of the terminals. Alternatively, a Merchant may access the services directly from its own POS system. In either case, Merchants access the services via dial-up phone calls over the public phone system, via connections over the Internet (through the Merchant's ISP), or via connections over dedicated lines. Other than the countertop terminal provided to certain Merchants during the brief pilot period, the [Taxpayer] does not provide its customers with any other equipment or communication services for use by the Merchant, either in the Merchant's stores or its headquarters locations to access the [Taxpayer's] Authorization or Discount Coupon Services.

The structure of the service fee varies depending on the service. For example, the fee for the Authorization Service is generally based upon the number of stores using the service. In this case, the number of transactions processed is not relevant to the billings. In contrast, the fee for the Discount Coupon Service is based on a risk model in which the [Taxpayer's] fee is equal to an agreed percentage of all net sales generated by purchases made on transactions in which the consumer coupon is redeemed. If the Merchant's customers do not use the coupons generated, then the [Taxpayer] receives no fee for this part of the service. The fee for each type of electronic information service (i.e., Authorization Services, Discount Coupon Services, or Set-up/Implementation Services) is shown as a separate line item on the [Taxpayer's] billing invoice, and the charge for the equipment provided during a pilot period, if any, is not separately sated but is included in the service fee on customer billings.

DISCUSSION

Based on the foregoing facts, Taxpayer requests a ruling as to whether three of its products are exempt from sales and use tax as services.

Pursuant to IC 6-2.5-2-1(a) and IC 6-2.5-2-2(a), sales tax is imposed on retail transactions made in Indiana. A retail transaction is defined in IC 6-2.5-4-1(b) as the transfer, in the ordinary course of business, of tangible personal property for consideration. IC 6-2.5-4-1(c) goes on to provide in pertinent part:

> For purposes of determining what constitutes selling at retail, it does not matter whether:
> . . .
> (2) the property is transferred alone or in conjunction with other property or services . . .

"Tangible personal property" is defined in IC 6-2.5-1-27 as:

> . . . personal property that:
> (1) can be seen, weighed, measured, felt, or touched; or
> (2) is in any other manner perceptible to the senses.
> The term includes electricity, water, gas, steam, and prewritten computer software.

Except for certain enumerated services, sales of services generally are not retail transactions and are not subject to sales or use tax. 45 IAC 2.2-4-2 clarifies the taxability of services as follows:

> (a) Professional services, personal services, and services in respect to property not owned by the person rendering such services are not "transactions of a retail merchant constituting selling at retail", and are not subject to gross retail tax. Where, in conjunction with rendering professional services, personal services, or other services, the serviceman also transfers tangible personal property for a consideration, this will constitute a transaction of a retail merchant constituting selling at retail unless:
> (1) The serviceman is in an occupation which primarily furnishes and sells services, as distinguished from tangible personal property;
> (2) The tangible personal property purchased is used or consumed as a necessary incident to the service;
> (3) The price charged for tangible personal property is inconsequential (not to exceed 10%) compared with the service charge; and
> (4) The serviceman pays gross retail tax or use tax upon the tangible personal property at the time of acquisition.
> (b) Services performed or work done in respect to property and performed prior to delivery to be sold by a retail merchant must however, be included in taxable gross receipts of the retail merchant.
> (c) Persons engaging in repair services are servicemen with respect to the services which they render and retail merchants at retail with respect to repair or replacement parts sold.
> (d) A serviceman occupationally engaged in rendering professional, personal or other services will be presumed to be a retail merchant selling at retail with respect to any tangible personal property sold by him, whether or not the tangible personal property is sold in the course of rendering such services. If, however, the transaction satisfies the four (4) requirements set forth in [subsection (a)], the gross retail tax shall not apply to such transaction.

A unitary transaction is clarified in 45 IAC 2.2-1-1(a) as follows:

> Unitary Transaction. For purposes of the state gross retail tax and use tax, such taxes shall apply and be computed in respect to each retail unitary transaction. A unitary transaction shall include all items of property and/or services for which a total combined charge or selling price is computed for payment irrespective of the fact that services which would not otherwise be taxable are included in the charge or selling price.

Sales of specified digital products are also included in the definition of retail transactions. IC 6-2.5-4-16.4(b) provides that a person engages in making a retail transaction when the person (1) electronically transfers specified digital products to an end user; and (2) grants to the end user the right of permanent use of the specified digital products that is not conditioned upon continued payment by the purchaser. "Specified digital products," as currently defined by IC 6-2.5-1-26.5, include only digital audio works (e.g., songs, spoken word recordings, ringtones), digital audiovisual works (e.g., movies), and digital books. Products "transferred electronically" are defined at IC 6-2.5-1-28.5 to mean products that are "obtained by a purchaser by means other than tangible storage media."

Pursuant to Section 333 ("Use of Specified Digital Products," effective Jan. 1, 2010) of the Streamlined Sales and Use Tax Agreement ("SSUTA," effective Oct. 8, 2014), of which Indiana is a signatory, "A member state shall not include any product transferred electronically in its definition of 'tangible personal property.'" Pursuant to the same section of the SSUTA, "ancillary services," "computer software," and "telecommunication services" are excluded from the term "products transferred electronically."

In order to stay in conformity with the SSUTA, Indiana may not impose sales tax on a product transferred electronically by basing the product's taxability on inclusion of the product in the definition of tangible personal property. It is important to note that "ancillary services," "computer software," and "telecommunication services" are not restricted by the phrase "product transferred electronically." However, IC 6-2.5-1-27.5(c)(8) explicitly excludes ancillary services from the definition of telecommunication services, which are taxable under IC 6-2.5-4-6. Accordingly, ancillary services are not subject to sales tax in Indiana.

Based on the foregoing, Indiana may impose sales tax on products transferred electronically only if the products meet the definition of specified digital products, pre-written computer software, or telecommunication services.

"Prewritten computer software" is defined in IC 6-2.5-1-24 as follows:

> Subject to the following provisions, "prewritten computer software" means computer software, including prewritten upgrades, that is not designed and developed by the author or other creator to the specifications of a specific purchaser:
> (1) The combining of two (2) or more prewritten computer software programs or prewritten parts of the programs does not cause the combination to be other than prewritten computer software.
> (2) Prewritten computer software includes software designed and developed by the author or other creator to the specifications of a specific purchaser when it is sold to a person other than the purchaser.
> (3) If a person modifies or enhances computer software of which the person is not the author or creator, the person is considered to be the author or creator only of the person's modifications or enhancements.
> (4) Prewritten computer software or a prewritten part of the software that is modified or enhanced to any degree, where the modification or enhancement is designed and developed to the specifications of a specific purchaser, remains prewritten computer software. However, where there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for such a modification or enhancement, the modification or enhancement is not prewritten computer software.

"Telecommunication services" is defined in IC 6-2.5-1-27.5 as follows:

> (a) "Telecommunication services" means electronic transmission, conveyance, or routing of voice, data, audio, video, or any other information or signals to a point, or between or among points.
> (b) The term includes a transmission, conveyance, or routing in which computer processing applications are used to act on the form, code, or protocol of the content for purposes of transmission, conveyance, or routing regardless of whether the service:
> (1) is referred to as voice over Internet protocol services; or
> (2) is classified by the Federal Communications Commission as enhanced or value added.
> (c) The term does not include the following:
> (1) Data processing and information services that allow data to be generated, acquired, stored, processed, or retrieved and delivered by an electronic transmission to a purchaser whose primary purpose for the underlying transaction is the processed data or information.
> (2) Installation or maintenance of wiring or equipment on a customer's premises.
> (3) Tangible personal property.
> (4) Advertising, including but not limited to directory advertising.
> (5) Billing and collection services provided to third parties.
> (6) Internet access service.
> (7) Radio and television audio and video programming services, regardless of the medium, including the furnishing of transmission, conveyance, and routing of the services by the programming service provider. Radio and television audio and video programming services include cable service as defined in 47 U.S.C. 522(6) and audio and video programming services delivered by commercial mobile radio service providers, as defined in 47 CFR 20.3.
> (8) Ancillary services.
> (9) Digital products delivered electronically, including the following:
> (A) Software.
> (B) Music.
> (C) Video.
> (D) Reading materials.
> (E) Ring tones.

With regards to the first issue, the question is whether the "Authorization Decision" part of the Authorization Services constitutes a transfer of tangible personal property, specified digital products, prewritten computer

software, or telecommunication services. As mentioned above, data from the Merchant is electronically transmitted to Taxpayer, which Taxpayer's analysts review using Taxpayer's proprietary algorithms and software. After that, the Taxpayer electronically transmits the merchant an Authorization Decision, which takes the form of:

> . . . a communication as to whether a return should be accepted or not, and [Taxpayer] provides its communication to the Merchant recommending whether the Merchant should accept or decline the merchandise return. To that end, a merchant receives the [Taxpayer's] communication (i.e., [Taxpayer's] opinion, advice or recommendation) in the form of an Authorization Decision signifying whether the Merchant is being advised to accept or reject the return (i.e., approved, warned, or denied).

The Authorization Decision would not fit under the definition of a "specified digital product," as it does not constitute a digital audio work, a digital audiovisual work, or a digital book. It would also not fit within the definition of "telecommunication service" or "computer software." For that matter, an Authorization Decision would also not fall under the definition of "tangible personal property."

Taxpayer's Authorization Services product appears to be a service under 45 IAC 2.2-4-2. Taxpayer charges a fee to its Merchant clients for customized information services. The Merchants do not pay a fee for individual Authorization Decisions, but a fee based upon the number of stores using the Authorization Service. Merchants submit specific customer information to Taxpayer, and Taxpayer produces a customized response. The customized response is not for sale to the public as a "canned" report. Therefore, the Authorization Service is not subject to Indiana sales or use tax.

For the second issue involving the Discount Coupon Service, the question is again whether the coupons constitute a transfer of tangible personal property, specified digital products, prewritten computer software, or telecommunication services. As Taxpayer described the Discount Coupon Service above, it is:

> . . . an add-on service that generates Merchant coupons to customers making returns to the Merchant. The Merchant coupon program is a proprietary, patented solution to achieve up-sell optimization by issuing intelligent incentives following legitimate return or exchange transactions. The coupons are printed by the Merchant directly on the Merchant's return receipts. . . . For this service . . . the [Taxpayer] receives payment in the form of commissions based on success, defined as incentives used, not just printed.

Taxpayer's Discount Coupon Service product also appears to be a service under 45 IAC 2.2-4-2, and not tangible personal property, specified digital products, prewritten computer software, or telecommunication services. Taxpayer charges a fee to its Merchant clients for a service customized to its customers. The Merchants do not pay a fee for individual coupons, but a fee "based on a risk model in which the [Taxpayer's] fee is equal to an agreed percentage of all net sales generated by purchases made on transactions in which the consumer coupon is redeemed." Taxpayer's coupons are submitted electronically to Merchant, and Merchant prints them on their return receipts. The coupons are customized to each of the Merchants' customers. The customized coupon also would not qualify as a "canned" report. Therefore, the Discount Coupon Service is not subject to Indiana sales or use tax.

The final issue is whether Taxpayer's fee to provide support for the integration of its services with its clients' systems, whether delivered inside or outside Indiana, are subject to sales or use tax when separately stated on customer invoices because they are nontaxable professional services under 45 IAC 2.2-4-2. According to Taxpayer's materials, the "integration" period occurs after a Pilot Period, in which "countertop VeriFone terminals" may be provided to their Merchant clients for a brief period of time, after which the Merchant would purchase its own terminals from third-party vendors. In a sample contract provided by Taxpayer, the "integration" services include:

> • Requirements analysis for making the then current production functionality of RAS accessible from Client's POS system.
> • Review of user interface changes to Client's POS system
> • Review of Client's designs for enabling its POS system to access the RAS through the RAS standard API
> • Consultation with Client on connectivity from Client's POS system to the RAS Access to a server for Client's use in testing its POS system with the RAS
> • Any additional integration, customization, programming, training or other services requested by the Client in writing beyond the standard POS implementation, will be billable at the Company's then applicable hourly rates.

None of these services are transferred in conjunction with tangible personal property. Therefore, Taxpayer's fee to

provide integration support is not subject to Indiana sales or use tax, as it relates only to professional or personal services under 45 IAC 2.2-4-2.

RULING

Taxpayer's Authorization Services, Discount Coupon Services, and the fee to provide support for the integration of its services all fall under services as enumerated in 45 IAC 2.2-4-2 and are therefore not subject to Indiana sales and use tax.

CAVEAT

This ruling is issued to the taxpayer requesting it on the assumption that the taxpayer's facts and circumstances as stated herein are correct. If the facts and circumstances given are not correct, or if they change, then the taxpayer requesting this ruling may not rely on it. However, other taxpayers with substantially identical factual situations may rely on this ruling for informational purposes in preparing returns and making tax decisions. If a taxpayer relies on this ruling and the Department discovers, upon examination, that the fact situation of the taxpayer is different in any material respect from the facts and circumstances given in this ruling, then the ruling will not afford the taxpayer any protection. It should be noted that subsequent to the publication of this ruling a change in statute, regulation, or case law could void the ruling. If this occurs, the ruling will not afford the taxpayer any protection.

Posted: 05/27/2015 by Legislative Services Agency
An html version of this document.